

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

Date: JAN 22 2001

Contact Person:

ID Number:

Telephone Number:

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the written information submitted, we have concluded that you have failed to establish that you are operated exclusively for one or more exempt purposes as required by section 501(c)(3) of the Code. The basis for our conclusion is set forth below.

You will operate a skilled care facility (nursing home), and an assisted living community for senior citizens. Your Articles of Incorporation do not contain a dissolution clause providing for your assets to be distributed to IRC 501(c)(3) organizations or purposes upon dissolution.

You stated you will be supported by [REDACTED] [REDACTED] has requested recognition as a tax exempt organization under section 501(c)(3) of the Code. [REDACTED] will appoint the majority of your Board of Directors. You have common Directors with [REDACTED]

[REDACTED] is your registered agent, President, Secretary and Treasurer. [REDACTED] is your Vice President. You have five Directors. Four of the five Directors have worked for the [REDACTED] ( [REDACTED] ), a for-profit company. [REDACTED] and [REDACTED] are the owners of [REDACTED]. They are also the owners of [REDACTED] ( [REDACTED] ), a for profit corporation from whom you will lease land and a building. You stated that after [REDACTED] and [REDACTED] resign, all of the Board of Directors will be "independent" of [REDACTED], [REDACTED], [REDACTED] and [REDACTED]. You also stated Board members will not be compensated for services to the board.

You stated you will contract with the management company to operate your facilities. [REDACTED] was in existence for many years managing the nursing home before you were formed. The founder and president of [REDACTED] is [REDACTED]. He is a 75% shareholder. The vice president of [REDACTED] is [REDACTED]. He is a 25% shareholder. Both are your officers, and, as such have established the terms of your contract with [REDACTED] even though the contract has not been finalized.

[REDACTED]

In response to our request for a copy of the management agreement between you and [REDACTED] you stated the agreement did not exist and will not exist until tax-exempt bond financing is obtained. You also stated that tax-exempt bond financing won't occur until you and [REDACTED] obtain tax-exempt status. You stated the management contract will be negotiated with the assistance of an independent consultant approximately 90 days prior to closing the sale of the building. In your application, you indicated that you will pay at least \$ [REDACTED] to the management company to manage your facility. This fee is based on 5 to 7% of patient service revenue and will be made up of:

1. Base Management fee of \$ [REDACTED] per bed (unit), and
2. Incentive fee tied to gross patient revenue, if operating targets are met.

You stated that prior to completion of the actual management agreement, [REDACTED] and [REDACTED] will resign, and will no longer be involved with you. You stated new independent officers will be appointed. You did not state when the present officers will actually resign. All of the work associated with the negotiation of the management contract has been completed. You stated the new officers will have experience in running a nursing home and an assisted care facility. Their salaries will be set at the time of hiring.

You will also pay \$ [REDACTED] a year as a license fee to [REDACTED] so that [REDACTED] can monitor quality assurance regarding resident care standards for nursing homes. [REDACTED] will also be the lessor of the ground lease of your facilities and will control the site and monitor patient care quality. You will pay fair market rent, determined by an independent appraisal, to [REDACTED] a related non-profit entity.

You stated you will purchase a [REDACTED] bed nursing home facility from [REDACTED]. The purchase price will be determined based on an appraisal of the fair market value of the building by an Appraiser with extensive knowledge of the nursing home industry. You stated the parties agree that the sale will reflect an arms-length transaction. As stated above, [REDACTED] and [REDACTED] own [REDACTED]. The facility is currently operated by [REDACTED] a for profit organization associated with [REDACTED].

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for health care purposes.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in

part to the benefit of private shareholders or individuals. The section cross references the definition of private shareholder which is contained in section 1-501(a)(1)(c). That section provides that the words private shareholder or individual in section 501 refers to person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Situation 2 of Rev. Rul. 69-545, 1969-2 C.B. 117, describes a hospital, otherwise serving a charitable purpose, that was denied exemption under section 501(c)(3) of the Code because it served a private interest more than incidentally. The revenue ruling states that in considering whether a nonprofit organization claiming charitable exemption is operated to serve a private benefit the Service will weigh all of the relevant facts and circumstances in each case.

Rev. Rul. 76-441, 1976-2 C.B. 147, ruled that a nonprofit organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are not related to the current directors, at salaries commensurate with their responsibilities is operated exclusively for educational and charitable purposes. An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors private interest and is not operated exclusively for educational and charitable purposes.

Rev. Rul. 80-287 concerns a lawyer referral service in which any member of the public can obtain an initial visit with a lawyer whose name is on an approved list maintained by the organization. The ruling states that providing services of an ordinary commercial nature in a community, even though the undertaking is conducted on a nonprofit basis, is not regarded as conferring a charitable benefit on the community unless the service directly accomplishes one of the established categories of charitable purposes. Although the lawyer referral service provided some public benefit, a substantial purpose of the program was the promotion of the legal profession.

Finding private benefit does not require the payments for goods or services be unreasonable or exceed Fair Market Value. See est of Hawaii v. Comm'r., 71 T.C. 1067 (1979). Similarly, in Church by Mail v. Comm'r., 765 F.2d Similarly, in Church by Mail v. Comm'r., 765 F.2d 1387 (9<sup>th</sup> Cir. 1985), aff'g. TCM 1984-349 (1984), the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973).

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), the Supreme Court held that the presence of a single non-exempt purpose, if

substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Leon A. Beechly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court was called on to decide whether benefits to third parties, who were not members, would prevent the organization from being recognized as an exempt organization within the meaning of section 501 (c)(3) of the Code. The Court concluded that the organization could not confer substantial benefits on disinterested persons and still serve public purposes within the meaning of section 1.501 (c)(3)-1 (d)(1)(ii) of the regulations.

Secondary benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose. Indeed, such a construction would cloud the focus of the operational test, which probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501 (c)(3) of the Code of a non-profit corporation that conducted continuing medical education tours. The petitioner had three trustees. Mr. Helin, who was a shareholder and the president of H & C Tours, a for-profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner shared offices with H & C Tours. The petitioner used H & C Tours exclusively for all travel arrangements. The petitioner's contract with H & C Tours permitted it to acquire competitive bids, but provided that H & C Tours would always get the bid if it was within 2.5%. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefitting the for-profit travel agency. It concluded that:

When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.

We find that a substantial purpose of petitioner's operations was to increase the income of H & C Tours. H & C Tours benefits from the distribution and production of brochures which solicit customers for tours arranged by H & C Tours. Approximately 90 percent of petitioner's total revenue for 1977 was expended on production and distribution of brochures. The terms of the Travel Service and Administrative Support Agreement further insured that H & C Tours would substantially benefit from petitioner's operations. Petitioner did not solicit competitive bids from any travel agency other than H & C Tours.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that a gaming organization was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial

benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place. The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view as follows:

Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994, indicates otherwise.

The Court concluded that KJ's Fund Raisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interests.

We have reviewed your proposed activities and based upon the information provided we have reached the conclusion that you are not operated within the meaning of section 501 (c)(3) of the code. It appears you will engage in substantial private benefit which is not incidental, in either a quantitative or qualitative sense, to your public purpose.

While you state that [REDACTED] and [REDACTED] will resign before you formally enter in to a management contract with [REDACTED] they have already negotiated with [REDACTED] a related organization, and with [REDACTED] a related organization. Your officers are also the officers and owners of [REDACTED] and [REDACTED]. There was not a board of disinterested persons negotiating the contracts with [REDACTED] and [REDACTED]. Nor did the board consider any other management and realty company other than the ones in which your officers had a financial interest. Your board members also have a financial interest in [REDACTED] as four of your five Directors have worked for, and been compensated by, [REDACTED]. This leads us to conclude that there is no independence between you and [REDACTED]. It appears your primary purpose is to further the financial interest of your officers. See, American Campaign Academy, Int'l. Postgraduate Medical Fndtn., KJ's Fund Raisers, Inc., supra. As the Court held in KJ'S Fund Raisers, Inc., supra, the fact that the original Directors of the non-profit company, who were also Directors of the for profit management company, left the new company before the IRS ruled on the exemption request was insufficient to show the independence of the later Board of Directors of the non-profit company. Similarly, here, the fact that two of your officers will resign before the actual sale of the nursing home occurs is insufficient to show your independence and is indicative that you were established for the private benefit of your officers.

The Income Tax Regulations place the burden of proof upon the organization to establish on application for exemption that it is not organized and operated for the benefit of private interests. Reg. 1.501(c)(3)-1(d)(1)(ii). Finding private benefit does not require the payments for goods or services be unreasonable or exceed Fair Market Value. See, est of Hawaii v. Comm'r., 71 T.C. 1067 (1979). Similarly, in Church by Mail v. Comm'r., 765 F.2d

[REDACTED]

1387 (9<sup>th</sup> Cir. 1985), aff'g. TCM 1984-349 (1984), the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The Court of Appeals stated that "the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church." You are similar to the organizations described above as [REDACTED] and [REDACTED] for profit organizations, will profit greatly from your arrangement with it. It is not enough that an independent appraiser will be used to review the management agreement, and the purchase price of the nursing home.

The Court in Church by Mail, *supra*, made clear that the reasonableness of compensation was not the pivotal issue; rather, it was the extent of the benefit given to the private party. Here, [REDACTED] will benefit to a substantial extent. You will pay [REDACTED] \$ [REDACTED] per year. [REDACTED] is owned and operated by your officers. Your President, [REDACTED], played a substantial role in your formation as well as your operation. Thus, you are operated for the private benefit of your officers.

Your Articles of Incorporation do not provide for the protection of your assets for tax-exempt purposes. The Articles do not provide for disposition upon dissolution to section 501(c)(3) organizations or for 501(c)(3) purposes.

Based upon the facts above, we have concluded that you are not organized or operated for exempt purposes as described in section 501(c)(3) of the Code. Therefore, it is our conclusion that you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue

[REDACTED]

Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service  
T:EO:RA:T:4 Rm. 3E5  
Attn: [REDACTED]  
1111 Constitution Ave, N.W.  
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack  
Manager, Exempt Organizations  
Technical Group 4